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SUBJECT: THE ECONOMY'S IMPACT ON THE ELECTIONS

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11. (U) This message is sensitive but unclassified and not for internet distribution.

12. (SBU) Summary: Growing concern about the economy is getting a lot of attention as a possible factor in the March 9 elections. It would only require a shift of two or three points to move the election one way or the other. Weak economic numbers and a very volatile stock exchange provide plenty of ammunition for the opposition conservative Partido Popular (PP). Clearly the weakening economy is not good news for the Zapatero government. Yet, it is not clear that the economy will prove to be a decisive election winning issue for the conservatives. The PP is certainly trying make it so though. The opposition is playing offense on the economy, especially through the recruitment of prominent businessman Manuel Pizarro to run in the number two spot on the PP's Madrid parliamentary list behind party leader Mariano Rajoy. The two parties' economic platforms are similar, and this election will not be fought over proposals for drastic change. Instead, the issues are whether the bad economic news will lead voters to punish the PSOE government. or whether the PP can make the case that it is better equipped to manage the coming economic turbulence. Our sense is that the economy alone will not likely be decisive. However, there is one issue related to the economy - immigration - where the PP, if it does not overplay its hand, might gain significant traction. The upcoming TV debate between Manuel Pizarro and Second Vice President and Finance Minister Pedro Solbes could also be significant. End Summary

#### SOME RECENT ECONOMIC/POLITICAL HISTORY

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13. (SBU) Spain has had a magnificent economic run over the last ten years. There really is no other way to put it. Since 1998, GDP growth has averaged 3.7%. From being a chronically underperforming economy with very high inflation and unemployment rates, Spain has now almost converged in terms of GDP per capita with the EU-15. The PP's 1996-2004 two governments get a lot of credit from Spaniards (even many socialists) for good economic management. But the socialists, while they may be considered dangerously left-wing by Spanish conservatives on foreign policy, social, regional autonomy, and Basque terrorism issues, are no wild-eyed radicals when it comes to the economy. After all, it was Felipe Gonzalez's government that got Spain into the EU in 1986. Membership in the EU forced a modernization of many Spanish institutions and provided access to EU development funds that have been used well by both socialist and conservative governments. Indeed, Spain will continue to be a net recipient of EU monies until 2013. Spanish socialists do not use soak-the-rich rhetoric and are committed to fiscal stability. The economy started supercharging with euro membership in 2002. The resulting arrival of what by Spanish standards were historically low European Central Bank interest rates allowed Spanish companies and households to borrow unprecedented amounts of money. One result has been

that real estate prices have almost tripled in Spain since membership in the euro. Since Zapatero took power in 2004, Spanish economic growth continued to be higher than average eurozone growth, with rates of over three percent a year. In fact, in 2007, the Spanish economy grew by 3.8%. In December last year, the EU's data compiler, Eurostat, reported that Spaniards were richer per capita than Italians. What this means is that while Spain is clearly on the cusp of more turbulent economic times, most Spaniards know that the last ten years or so have been among the most prosperous they have ever enjoyed. Yes, some house prices have stagnated, particularly in important markets like Madrid and Barcelona. However, most homeowners still have considerable equity in their properties. Moreover, mortgage collateral requirements are high so widespread defaults are unlikely. Spaniards do complain about rising consumer prices; inflation remains stubbornly above the eurozone average. There are those who have not shared in Spain's economic progress. Wages are low for many people. But, by and large, most Spaniards are still doing quite well after ten years of rapid economic growth.

#### RECENT ECONOMIC NUMBERS NOT SO GOOD THOUGH

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¶4. (U) In terms of growth, 2007 was another strong year for Spain with 3.8% growth. But, starting in the fall, signs of weakness started to emerge.

¶5. (U) GROWTH: Although the widely forecast end of the housing construction boom had begun earlier in the year, discussions about possible economic growth numbers in 2008 started in earnest in the fall when the effects of the U.S. sub-prime crisis started to be felt by French and German

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banks. The IMF began revising global 2008 growth projections downwards, including its projection for Spain. The IMF now estimates that 2008 Spanish growth will be 2.7%; the OECD estimates 2.5%. The Spanish government's original 2008 growth projection was 3.3%. Then it revised the projection downwards in December, 2007 to 3.1%. Subsequently the government has hinted it might be something between 2.8% and 3.1%. The conservative El Mundo newspaper reported on 2/6/08 that the GOS is considering revising the 2008 growth projection down to 2.6%. Growth of 2.6% would still be higher than average expected eurozone economic growth, and this would not necessarily put Spain in a recession (defined as two consecutive quarters of negative growth). According to a Bloomberg/World Bank forecast, in 2008 Spain will grow by 2.8% and the eurozone by 2.0%. So, on the face of it this would not be so bad. But, for reasons explained below, a lot of people are still likely to feel some economic pain over the coming year or so.

¶6. (U) INFLATION: In recent years, the inflation rate has typically been about a percentage point or more higher than the eurozone average. More and more stories started showing up in the press about six months ago about higher prices, particularly for basic foodstuffs and certain services like, for instance a cup of coffee in a bar or restaurant. President Zapatero himself has not been particularly sensitive on this issue. When asked on a popular TV program what the price of a cup of coffee was, he replied about 80 cents when in reality most Madrid establishments charge a euro or more. Second Vice President and Finance Minister Pedro Solbes has not demonstrated great sensitivity on this topic either. He suggested recently that one reason inflation was so relatively high in Spain was that Spaniards had not quite internalized the true value of a euro. Hence they often tipped a euro for two coffees costing a euro each, driving prices upwards. This sounds trivial, but in a culture that puts a premium on going out, the fact that Zapatero and Solbes seemed so out of touch with everyday life got a lot of media play. The full-year 2007 inflation number was 4.2%, which also generated a lot of media interest and

solidified a widespread sense that goods and services are getting more expensive and wages are not keeping up. The conservatives are using this for all it is worth and noting that inflation tends to hurt the less well off the most. For instance, the PP's Social Affairs spokesperson, Ana Pastor, noted in a speech earlier this month that fixed-income retirees are particularly vulnerable to price rises in basic foodstuffs, and that these items had risen the most recently.

17. (U) UNEMPLOYMENT: Unemployment is inching upwards as well.

Fourth quarter 2007 unemployment was 8.6%, up from 8.3% earlier. In January 2008, registered unemployment went up by 132,000 people, the biggest monthly jump since 1986. While some socialist-leaning analysts suggested that the number may be artificially inflated due to one-time factors, even the socialist government's Labor Minister, Jesus Caldera, says the number is "bad, very bad". Employment or lack thereof is an important issue, especially as there are memories from the seventies and eighties of unemployment rates of 16% or more. For Spain though, an unemployment rate of 8.5% or so is historically good, particularly given the fact that over the last seven years, the Spanish population has increased from about 40 million to 45 million with the increase entirely attributable to immigration. The immigrants have tended to be in prime working age as well. Many of them found jobs in Spain's construction and tourist sectors. The former sector is going through a slowdown, at least with respect to residential construction. Immigrants do not vote in as great numbers as native born Spaniards (some have not naturalized yet of course) so it is not clear what impact leaner economic times will have on their vote. The Secretary General of Spain's largest trade union (which has similar views to the PSOE), Candido Mendez, said in a 2/11/08 El Pais interview that the unemployment numbers would have a "limited" impact on the election result because unemployment was still low by historical Spanish standards and many more Spanish workers were eligible for unemployment compensation than had been eligible during previous increases in unemployment. Nonetheless, even if most Spaniards still have a job, the higher unemployment figures contribute to an overall sense that the long economic expansion is exhausting itself.

18. (U) HOUSING (see ref A): Spaniards of widely varying socioeconomic backgrounds obsess about housing. Roughly 80% of Spanish households are homeowners. Very often, marriage is delayed until the couple can afford to buy a property. For several years in a row, Spain has built more houses than the UK, France and Italy combined. Prices have tripled in the last six or seven years. But, finally, the long residential construction boom is cooling down. Sales of both new and used homes decreased steadily in 2007 with 232,358 registered sales in the first quarter and only 188,256 in the

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third quarter. Housing starts in August 2007 were reportedly down 40% compared with August 2006. There are now even signs the prices are starting to come down. A January 2008 survey showed that used home prices in Madrid and Barcelona were down 0.3% and 2% respectively. So far, the slowdown in housing has not led to widespread defaults. Most Spaniards can still meet their variable interest rate mortgage payments, even if it means cutting consumption elsewhere (which of course has wider economic implications). Younger first-time home purchasers might be grateful for prices to level out for a while. But, less residential real estate construction has significant employment effects. Housing Minister Carme Chacon recently speculated that 250,000 fewer homes would likely be built in 2008. One industry representative calculated that this would lead to the disappearance of about 300,000 jobs. Again though, more pertinent to the March elections, is that most Spaniards still have considerable equity in their properties, although they know real estate is probably in for a fairly lengthy correction.

¶9. (U) THE STOCK MARKET: The Madrid stock market, the Ibex-35 (a blue chip index of the 35 of the most highly traded stocks in Spain) has lost considerable value and has been highly volatile. At its height late last year, the market reached 16040,4. At its lowest last month, the market plunged below 12,000, a loss of over a fourth of its value in just a few months. As of 2/6/08, the Ibex-35 traded at 13,037.30. In recent weeks, volatility has been exceptionally high. For instance, during the week of January 21, on one day the market went down by a little over 7%. Two days later it surged upward by almost 7%. There is nothing particularly special about how the Spanish stock market has behaved. Arguably, the Spanish stock market has simply mirrored the volatility from around the world. Besides, unlike Americans, most Spaniards do not invest directly in the stock market. Company-sponsored 401 (k) equivalents are not common so the proverbial man or woman on the street typically does not check stock quotes frequently as, for instance, so many Americans did towards the end of the tech boom. Nonetheless, after years of steady gains, the market's gyrations have been cause for a lot of media attention, and the market's woes contribute to a general sense of economic malaise. Moreover, the mere fact that the Spanish stock market is acting like markets elsewhere is unsettling because Spain has enjoyed better than average economic performance for about ten years.

¶10. (U) ECONOMIC CONFIDENCE: During the December 18-27, 2007 period, the Center for Sociological Research (CIS) conducted a poll showing that almost 36% of the respondents think that the economy is "bad" or "very bad". About 44% think it is moderately bad (the Spanish word is "regular", which has slightly negative connotation). Only 18% of the respondents think it is "very good". The CIS reports that its economic confidence indicator is the lowest in 12 years. Moreover, in its November barometer, economics appeared as one of the top three issues to the respondents, a first in many years. Almost a third of the polled individuals believe the economy will be worse in a year. Anecdotally, the difference in expectations over the last six months is palpable.

PP STARTS FOCUSING ON ECONOMY  
AND LAUNCHES MANUEL PIZARRO  
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¶11. (SBU) During the last four years, the opposition has focused its criticism of the Zapatero government on Basque terrorism, regional autonomy matters, and social issues. Economics only started to get more PP attention in the last six months or so after expectations for 2008 began to deteriorate. The opposition started by highlighting inflationary pressures on the Spanish economy and then emphasized other bad numbers as they have started to come in. For instance, on 2/6/08, opposition leader Mariano Rajoy sounded the alarm by characterizing the increase in unemployment registrations in January as un "autentico drama". The government's immediate and predictable rejoinder was that unemployment was 11.5% in 2004 when it took over from the PP so the 8.6% rate in 2007's fourth quarter was not so bad. Besides specific electoral proposals, the PP's biggest initiative in terms of trying get traction on the economy was the 1/15/08 announcement that former CEO of Spanish electricity giant Endesa, Manuel Pizarro, would run just below Mariano Rajoy in the number two spot of the PP's Madrid parliamentary list (ref B). The PP did not get quite the bump it wanted from the recruitment of this prestigious, if controversial, businessman because the exclusion of Madrid Mayor Alberto Ruiz Gallardon from the list overshadowed the launching of Pizarro. However, the Pizarro appointment did serve to highlight the PP's renewed attention to economic matters. Since Pizarro's formal incorporation into politics, he has made a few speeches and issued a couple of statements.

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Importantly, he also traveled to Catalonia in a public attempt to mend fences with the Catalan business community,

sectors that are still angry at his strong opposition to Barcelona-based Gas Natural's takeover bid for Endesa. However, it is not yet clear to what extent he will have an impact. A lot will depend on the planned TV debate between himself and Second Vice President and Finance Minister Pedro Solbes. At least in public, Solbes seem to relish the upcoming debate. Solbes points out that while Pizarro may be a successful businessman (a double edged compliment given that many people think that his pay packages have been a little too rich in recent years, at least by Spanish standards), he has no real experience managing and/or formulating macroeconomic policy. During a 2/10/08 PSOE rally, Solbes noted that he has thirty years of working for Spanish citizens, not shareholders. This points to a weakness for the PP. Many people within the conservative camp would have liked to convince former IMF Chairman and former Finance Minister Rodrigo Rato to return to active politics. Getting him to return to Spanish politics would have been a much more significant coup for the conservatives.

He would have given the PP's statements on macroeconomic policy immediate credibility. However, Rato has chosen to sit out this election (some people think he wants the top PP job if Rajoy leads the party to defeat next month) and take lucrative positions with Lazard Freres and Banco Santander.

#### PSOE AND PP ECONOMIC PROPOSALS

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¶12. (U) The main contours of the parties' proposals are quite well known, and they focus on tax cuts. There follow below the main PSOE and PP proposals.

#### ¶13. (U) PSOE Economic Proposals

##### Tax Policy

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- 400 euro rebate for those deriving income from work or pensions
- reduction of income taxes (undefined)
- elimination of wealth taxes
- exemption of estate taxes for all estates worth less than euros 60,000
- reductions in corporate taxes (undefined)

##### Social Policy and Pensions

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- creation of 300,000 day care spots for children up to three years old
- extension of paternity leave from two to four weeks
- extension of maternity leave from 16 to 18 weeks for the birth of a  
second child to single parent homes; 20 weeks for the third child
- parents of children up to 12 have a right to part-time work (not clear how this would work  
in practice)
- schools will be open from 7:30 AM to 8:00 PM Monday to Friday, 11 months of the year
- increase of euros 200 in monthly minimum wage by the end of the government's term in 2012

##### Employment

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- creation in two years of two million jobs
- reduce unemployment rate to 7%

- reduce part-time wage contracts by 25%
- increase minimum wage to euros 800

#### ¶14. (U) PP Economic Proposals

##### Tax Policy

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- people earning less than euros 16,000 per year would be exempt from income taxes (that would mean about 7 million people would no longer pay income taxes)

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- women would get a euro 1,000 tax cut
- there would be 3, as opposed to 4, income tax rates: 20%, 30% and 40% (rates are currently 24%, 28%, 37%, and 43%)
- corporate taxes would come down to 25% from 30%; SME's would pay 20%, down from 25%
- elimination of estate tax

##### Social Policy and Pensions

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- creation of 400,000 day care places for children up to three years old
- increase per child tax deductions by 40%
- obtain a 3% of GDP budget surplus; create monitoring bodies to fight inflation
- increase minimum pensions by 150 euros

##### Employment

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- creation of 2.2 million new jobs
- increase female labor force participation rate to 68%

#### WHAT WOULD THESE PROPOSALS COST?

¶15. (U) There are no clear-cut estimates of what these ideas might cost, and what impact their adoption might have towards meeting both political parties' goal of continuing to run budget surpluses. El Pais reports that the government estimates that the euro 400 tax rebate would cost euros 5 billion. El Pais reports that it talked to a number of PP economic policymakers off the record who suggested that their tax cut proposals might, at least initially, cost up to three times as much as the PSOE's proposals. The PP is less willing to speculate regarding what its ideas might cost for two reasons. There are presumably those in the party that believe in the dynamic effects of tax cuts, particularly the cut in the top marginal income tax rate, but they are unwilling to estimate publicly how much extra revenue might accrue to the treasury as a result of supply-side effects. The more traditional fiscal hawks suggest they might be able to pay for some of the income tax cuts by increasing indirect taxes, but they are certainly not going to advertise that idea before the elections.

#### WHAT DO THESE PROPOSALS SAY ABOUT THE POLITICAL PARTIES?

¶16. (SBU) Up to a point, the two parties' proposals compete for whom can lower taxes more or promise to create more jobs. One PSOE contact ridiculed the fact that after the PSOE said it would try to create 2 million new jobs, the PP countered

with 2.2 million. Ditto with respect to day care places. The PSOE offered 300,000 and the PP 400,000. But the parties' proposals do say something about their thinking. The traditionally leftist PSOE offers tax cuts, including the elimination of the wealth tax. The socialists also offer more spending, but the party's tax cut ideas have overshadowed the spending plans, not typical for a center-left party. Indeed, the successor to the Spanish communist party, Izquierda Unida (IU), has criticized the PSOE for engaging in a tax cut competition with the PP, thereby in IU's view undervaluing the role of the public sector. The PP offered a modest supply-side tax reduction that would lower the top rate to 40% from 43%. However, its proposals to eliminate income taxes for those earning less than euros 16,000 have gained more prominence than the marginal income tax rate reduction proposal. (Note: Former Presidency Economic Office Director and former Madrid mayoral candidate Miguel Sebastian recently told DCM that the socialists have deliberately not criticized the PP proposal as a gift to the rich, presumably because the socialists do not want to be perceived as a traditional soak the rich left-wing party.) And for a party that says it wants reduce the role of government, the PP's spending proposals are not cheap. What does this all say? At least with respect to economic policy (not social issues like gay marriage or constitutional issues such as the powers of the regions), both political parties look to the center. There certainly are some differences. For example, the PSOE promises less with respect to both tax cuts and spending, perhaps a reflection of the fact that it thinks it has a somewhat better than even chance of remaining in office. The PP offers somewhat more to the better-off. But the truth is

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that both political parties' ideas on the economy are so similar that the differences tend to get blurred. There will be a debate as to which party is better in terms of managing the economy in tougher times, but it is difficult to believe that the parties' substantive economic proposals will tip the balance one way or another.

PUNDITS AND POLLS INCONCLUSIVE  
REGARDING THE IMPACT OF THE  
ECONOMY ON THE ELECTIONS

17. (SBU) DCM hosted a lunch recently for major newspaper editors of all major political persuasions. They all had a lot to say about the economy, but none of them thought that the economy per se would have a major impact on the election result. DCM also hosted a lunch last week for six major economic pundits, some who support the PP and others the PSOE. They engaged in a very lively debate about the economy. There were occasionally heated exchanges, for instance on whether the latest unemployment statistics really reflected what was going on in the economy or not. But the pundits were very reluctant to hazard a guess as to whether the economy would make the difference in the election result.

One PP oriented economist said yes, the economy will be a critical issue because the PP was more trusted to handle an economic crisis in his opinion. But subsequently he would not hazard a guess as to which side would win. Former Director of the Presidency Economic Office and failed Madrid mayoral candidate Miguel Sebastian contrasted the PP's comments about the economy in 1996 with their comments today.

In 1996 the PP expected to win, Sebastian said, and therefore had optimistic things to say about the economy because they did not want to damage public expectations. This year, he said, the PP expects to lose and therefore sees no downside to spreading doom and gloom about the economy, as it will not have to manage the fallout. This acerbic comment from Sebastian capped a somewhat bitter exchange regarding whether pessimistic comments about the economy could in the end precipitate unnecessary damage on the economy. The socialists have accused the conservatives of a lack of

"economic patriotism" in this context. The conservatives attack the socialists for a lack of realism. In recent weeks, the Embassy has sent political officers to Andalucia, the Basque Country, Valencia and Navarra to talk to people in widely different positions and from widely different political persuasions about the elections. The Embassy officers asked whether the economy would make a significant difference in the election results. Most people thought that the latest economic numbers certainly do not help the socialists. However, the prevailing opinion seems to be that the more adverse economic circumstances will not have affected a sufficiently large number of people by March 9 to prompt many people to change their votes.

¶18. (U) Spanish newspapers publish polls regularly. Most of them need to be interpreted carefully though because the Spanish press is so partisan. A 1/23/08 Cadena Ser (more socialist-leaning) poll asked whether the PP or the PSO could solve better the country's economic problems. Some 40% said the PSOE and 39.2% said the PP. On the other hand, a 2/3/08 EL Pais (socialist-leaning) poll found that 43% of the respondents said that the PP was best placed to restart the economy and 37% said the PSOE. A 2/10/08 El Pais poll found 50% of the respondents think that the economy is bad or very bad. But, 43% say their personal financial situation is good or very good. A recent ABC (conservative newspaper) poll shows that 32% of the respondents think that the PP is best placed to manage an economic crisis versus 28% for the PSOE. The poll showed that 56% of the respondents think that the Spanish economy will perform roughly the same as the rest of Europe, perhaps suggesting that many people think that tougher economic are not necessarily "made in Spain". This is consistent with the government's frequent emphasis in public statements that the current economic worries result from the U.S. sub-prime crisis rather than the long-expected end of the housing boom. Other polls that have come out in the press have tended to give one or the other of the major parties an advantage on this issue, but usually the advantage is within the margin of error.

#### IMMIGRATION EMERGING AS AN ISSUE

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¶19. (SBU) The economy has performed so well in recent years that Spain's absorption of five million immigrants in the last seven or eight years has so far not had major political consequences. But that may be beginning to change. Spain's education and health systems are under pressure to deal with the newcomers and maintain previously reached standards. On 2/6/08 Mariano Rajoy proposed that immigrants be obliged to sign a contract "to respect Spanish customs", an initiative

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modeled on French President Sarkozy's ideas on immigration. The socialists immediately accused the PP of xenophobia. But, according to a poll conducted by El Pais, 56% of the respondents support the measure. Most pertinently, 45% of socialist voters support the proposal. This is an issue where the PP may be able to make some headway. However, the conservatives need to be careful not to overplay their hand. The PP's economics and employment spokesperson, Miguel Arias Canete, complained on 2/7/08 about the quality of waiters in Spain nowadays and that an Ecuadorian woman could get a mammography for free in Spain in 15 minutes, rather than spend the equivalent of nine months of her salary in Ecuador.

Statements of this kind make it fairly easy for the socialists to portray the conservatives as callous. After all, millions of middle class Spaniards depend on immigrants from Latin America, especially for child care and elder care.

Rajoy has been careful to talk about the benefits of immigration as well as the need for stricter immigration controls and an obligation on the part of immigrants to follow Spanish customs. This suggests that the PP leadership is aware of the need to straddle a fine line on this issue.

COMMENT

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¶20. (SBU) Economists from both political parties recognize that Spain has two major economic challenges. First, in the short-term how to deal with effects of slowing growth. With respect to this challenge, Spain can use fiscal stimuli given the budget surpluses it has racked up in past years. With respect to the second challenge, both parties are flush with proposals. However, there are no major policy differences reflecting the general consensus in Spanish society on economic issues. Indeed, Spain's long run of economic success means that neither party is recommending a French-style economic "rupture" with the past. Both parties, however, will make the case that they are better able to manage the coming economic turbulence. Who the voters ultimately trust to run the economy could be significant in this coming election.

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